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The capital maintenance concept and share repurchases in South African law

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*188 The capital maintenance concept

The South African Companies Act 61 of 1973 adopts a strange and a curious ambivalence towards the nineteenth-century common law concept of the maintenance of the share capital of a company. In some respects, the Companies Act still clings to this archaic and outdated concept, while in other respects, it boldly sweeps away the concept and replaces it with the more modern twin tests of "liquidity" and "solvency" as a form of creditor protection.

According to the capital maintenance concept, the issued share capital of a company is seen as a guarantee fund or a permanent fund intended for the payment of the claims of the creditors of a company, with the result that the issued share capital of a company may not be reduced, nor may it be returned to shareholders except where the Companies Act or the common law authorises it. Thus, Lord Halsbury, L.C., in *The Ooregum Gold Mining Company of India Ltd v Roper,* [1] declared that "[t]he capital is fixed and certain, and every creditor of the company is entitled to look to that capital as his security". This was echoed some eight decades later in *Cohen NO v Segal,* [2] where the court, in prohibiting the payment of a dividend out of share capital, proclaimed that

"[w]hatever has been paid by a member cannot be returned to him and no part of the corpus of the company can be returned to a member so as to take away from the fund to which the creditors have a right to look as that out of which they are to be paid.The capital may be spent or lost in carrying on the business of the company, but it cannot be reduced except in the manner and with the safeguards provided by the statute."

In accordance with this concept, ss.81 and 82 of the Companies Act prohibit a company from issuing its shares at a discount unless certain stringent precautions have been complied with. Section 79 prohibits a company from paying interest on shares out of share capital unless this is authorised by the articles of association of the company or by a special resolution, the interest paid is restricted to a maximumof six per cent per annum, and the approval of the Minister of Industries, Commerce and Tourism has been obtained.

These statutory provisions find their roots in the capital maintenance concept, but it no longer makes any sense to preserve them in their present form, because instead of complying with the burdensome requirements of s.79, a company may now simply makea "payment" including dividend payments in terms of s.90 (as amended in 1999), whether out of capital or profits, to its shareholders provided that this is authorised by its articles of association and that it satisfies the tests of "liquidity" and "solvency" (as explained below). A company may, if it so desires, prohibit in its articles of association such "payments". Section 90 abandons the common law concept of capital maintenance and together with it the fundamental common law principle that dividends may only be paid out of distributable profits. Unlike English law, ss.83 and 84 which regulated reductions of share capital have been repealed by s.8 of the Companies Amendment Act 37 of 1999, with the result that there is no longer any statutory procedure for the reduction of a company's share capital, except in accordance with s.90 of the Companies Act. Perhaps this conflict in the underlying philosophy and policy of the South African Companies Act is a direct result of the patchwork and piecemeal reform that has taken place in South African corporate law during the 30-year existence of the Companies Act of 1973. By way of contrast, ss.135-141 of the UK Companies Act 1985 have preserved the statutory procedures and regulations relating to reductions of share capital.

Share repurchases

Another vital aspect of the reform of the capital maintenance concept is the right conferred by s.85 of the Companies Act (as amended by s.9 of the Companies Amendment Act 37 of 1999) to enable companies to purchase their own shares. Until 1999, South African corporate law was one of the few remaining common law jurisdictions which continued to prohibit companies from purchasing their own shares, as laid down by the House of ***189** Lords in *Trevor v Whitworth.*[3] This prohibition has finally been thrown overboard.

While the capital maintenance concept has been abandoned to this extent, it still remains essential to protect not only creditors from the potential abuse of the share repurchase power but also shareholders, since they are at risk if the share repurchase power is used by a company to discriminate against shareholders holding the same class of shares. A share repurchase also affects voting rights and therefore control of the company.

In *Capitex Bank Ltd v Qorus Holdings Ltd,*[4] the first case dealing with the statutory provisions relating to share repurchases, the court, correctly with respect, ruled that while the statutory provisions have dramatically changed the capital maintenance rule and the perceived protection it afforded to shareholders, the rule continued to have some residual function in South African law in that it remains an important guideline to protect creditors and shareholders against abuse of the power of a company to repurchase its own shares.

The statutory provisions on share repurchases

Section 85(1) of the Companies Act 1973, as amended by the Companies Amendment Act 37 of 1999, enables a company to acquire its own shares provided that it is authorised to do so by its articles of association and the share repurchase has been approved by a special resolution passed by the members of the company. Such approval may either be a general approval which is valid until the next annual general meeting unless varied or revoked earlier (s.85(2) and (3)), or it could be a specific approval for a particular acquisition (s.85(2)). The latter provision facilitates a share repurchase for the purposes of an employee share scheme, or a share repurchase in order to settle a debt owed to the company, or a share repurchase from the estate of a deceased shareholder or to effect a repurchase of an odd lot parcel of shares.[5]

The "liquidity" and "solvency" tests

The core of the statutory provisions permitting share repurchases is to be found in s.85(4)(a) and (b) of the Companies Act, which prohibits a company from making any payment in whatever form for the acquisition of its shares if there are reasonable grounds for believing:

(a) that the company is or would *after* the payment be unable to pay its debts as they become due in the ordinary course of business (this is known as the "liquidity" test); or

(b) the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company (this is known as the "solvency" test).

Section 85(4)(a) and (b) thus ensures that a company that is insolvent *or* illiquid, or which will become insolvent or illiquid as a result of the share repurchase, cannot proceed with the transaction. It is also clear from the wording of the section that the liquidity and the solvency tests are both objective, and that both tests must be satisfied for a valid share repurchase. In *Capitex Bank Ltd v Qorus Holdings Ltd,* [6] the court held that in view of s.85(1) of the Companies Act, an agreement relating to the acquisition by a company of its own shares is no longer, in itself, illegal or unlawful, but that a payment made in contravention of the liquidity and solvency tests as embodied in s.85(4)(a) and (b) would result in the illegality of the share repurchase agreement.

There are no restrictions on the source of the funds utilised to acquire the company's shares. Such restrictions were, until the simplification of the financial provisions relating to the validity of distributions, quite common in the United States. [7] In English law, s.160(1) and (2) of the Companies Act 1985 requires shares to be repurchased either out of distributable profits or out of the proceeds of a fresh issue of shares made specifically for that purpose. In the case of a private company, the company may under certain circumstances make a payment out of capital (*i.e.* the permissible capital payment) (s.171) provided that the directors in terms of s.173(3) make a statutory declaration.

It is also clear from the wording of s.85(4) that all that is required is that the company has "reasonable grounds" for believing that it is liquid and solvent. Unlike s.173(3)-(6) of the UK Companies Act 1985, an auditor's report or certificate is not required, even in the case of shares listed on the Johannesburg Securities Exchange ("JSE"). [8] There is also no prescribed minimum period after the share repurchase for which the company must remain liquid and solvent, although in the case of listed shares, r.5.69(c)(i) and (ii) of the JSE Listings Requirements requires a statement from the directors that the company will remain liquid and solvent for a ***190** period of 12 months of the date of approval of the offering circular, and that its share capital reserves and working capital will be adequate for ordinary business purposes for a period of 12 months after the date of the approval of the offering circular.

The liability of the directors, and the rights of creditors and shareholders

It is the responsibility of the directors of the company to ensure that a share repurchase does not cause the company to become insolvent or illiquid. If it does, the directors become jointly and severally liable to restore to the company the amount paid by the company for the share repurchase and not otherwise recovered by the company, subject to any relief granted by the court in the exercise of its discretion under s.248 to excuse a director who has acted honestly and reasonably and who ought fairly to be excused (s.86(1)). The company, however, commits no criminal offence as it does in Singapore; nor is it directly liable to its creditors or shareholders. In South African law, the directors do not owe any fiduciary duty to the creditors of the company.

A director held liable under s.86(1) is entitled to apply to the court for an order compelling the selling shareholder to pay to the *company* any money paid to him by the company in breach of s.85(4). This right of recovery against the selling shareholder is extended also to creditors before or at the time of the repurchase and to shareholders, even shareholders subsequent to the share repurchase. But the statutory provisions do not expressly permit a creditor or a shareholder to directly sue the directors of the company if the company has failed to comply with the liquidity and solvency tests.

The procedure for a share repurchase

The procedure for a share repurchase is of crucial importance in preventing abuse of the share repurchase power and discrimination against shareholders holding the same class of shares. Two types of procedures are provided for: (i) a tender offer in terms of s.87(1) of the Companies Act, which entails an offer to acquire unlisted shares from all registered shareholders; and (ii) a repurchase on the open market. It is clearly desirable that a company repurchases its shares from all the shareholders on a *pro rata* basis so that all shareholders are given the right where reasonably practicable to participate on an equal basis. In accordance with this underlying theme, s.87(1) requires in the case of unlisted shares that the company delivers or posts to each registered shareholder a copy of a prescribed offering circular stating the relevant details of the share repurchase. Shareholders could in response to this circular offer to sell shares to the company, and should they offer to dispose of a greater number of shares than that which the company offered to acquire, the company is required to acquire the additional shares on a *pro rata* basis. Failure to comply with the requirements of s.87(1) constitutes a criminal offence, and penalties are also prescribed for untrue statements in the offering circular.

This procedure does not apply in two cases: first, a repurchase of shares listed on a stock exchange, the reason for this exclusion being that the JSE has prescribed its own (and more effective) safeguards and procedures for a share repurchase; and secondly, where a company is acquiring its shares in terms of a specific approval for a particular acquisition as provided for in s.85(2). In such cases, an offering circular is not appropriate and is dispensed with.

No Treasury shares

The Companies Act stipulates (in s.85(8)) that repurchased shares must be cancelled as issued shares and be restored forthwith to the status of authorised shares. Following the trend in New Zealand (s.66(1) of the New Zealand Companies Act 1993), Australia (s.257 H (3), Division Two, Corporations Act 2001) and Canada (s.39(6) of the Canada Business Corporations Act 1985, RSC 1985, C-44), there are to be no Treasury shares in South African law. Treasury shares are fully paid issued shares of a company that have subsequently been repurchased by the company and which the company, instead of having to cancel on their repurchase, is permitted to reissue for what they will fetch on the open market. [9]

Since the repurchased shares are cancelled on their acquisition, it follows that any rights or privileges attaching to such shares, such as voting or dividend rights, are also extinguished.

There is, however, one exception to the rule that the repurchased shares must be cancelled, and this arises where a subsidiary acquires shares in its holding company, which it is now permitted to do up to a maximum of 10 per cent of the issued shares of the holding company (s.89). In this case, the repurchased shares of the holding company need not be cancelled, but such shares do not carry any voting rights, although nothing is said of dividend rights (s.89 and s.39).

Insider trading

Another disappointing omission in the statutory provisions on share repurchases is that a company ***191** repurchasing its shares, or intending to do so, does not acquire the status of an "insider" for the purposes of the Insider Trading Act 135 of 1998, even if the company is in possession of material non-public information relating to its securities. The Insider Trading Act applies only to natural persons, although an "individual" that encourages a company to deal, or discourages it from dealing, on the basis of material non-public information would, according to s.2(1)(b) of the Insider Trading Act, commit a criminal offence. Thus, a director of a company who causes the company to deal in its securities would commit a criminal offence, but the company itself cannot be convicted of the offence. Section 52 of the Criminal Justice Act 1993 has a similar effect in the United Kingdom.

In sharp contrast, in New Zealand, Australia and Canada, a company is treated as an "insider" of itself when it repurchases its own shares. The New Zealand Law Commission Report [10] went so far as to describe a company repurchasing its own shares as the "ultimate insider". The policy ought to have been that companies ought not to be permitted to repurchase their own shares until such time as any material non-public information that they may have relating to their own securities has been made public. It is respectfully submitted that the issue has not been properly considered in South African law, particularly since the Insider Trading Act 1998 was enacted before companies were given the right to purchase their own shares.

Conclusion

The provisions of the Companies Act relating to share repurchases are in some important respects defective and lacking in technical quality. Although we still have much work to do in developing our law relating to share repurchases, we have nevertheless made considerable progress in partially abandoning the outdated concept of capital maintenance. South African law is now more or less in harmony with the law in other common law jurisdictions, but we await judicial interpretation and clarity on some of the more ambiguous and uncertain provisions of the Companies Act.

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Footnotes

1 [1892] A.C. 125 at 133.
2 1970 (3) S.A. 702 (W) at 705H.
3 (1887) L.R. 12 App. Cas. 409, HL.
4 2003 (3) S.A. 302 (W) at 308I-309A.
5 See, further, F.H.I. Cassim, "The New Statutory Provisions on Company Share Repurchases: A Critical Analysis" (1999) 116 S.A.L.J. 760, where share repurchases are discussed in more detail; see also F.H.I. Cassim, *Annual Survey of South African Law* (1999), pp.402-408.
6 Above, n.4.
7 See, for instance, s.6 of the US Model Business Corporations Act 1969, which has now been replaced by more streamlined provisions.

8 See the new JSE Listings Requirements which came into force on September 1, 2003.
9 See Hand J. in *Borg v International Silver Co,* 11 Fed. (20) 147 (1925).
10 Report 9, Company Law Reform and Restatement (June 1989), para.413 at p.100.

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